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| TO: | The Honorable Shap Smith, Speaker of the House of Representatives and The Honorable Peter Shumlin, President Pro-Tempore of the Senate |
| FROM: | Thomas M. Salmon, CPA, State Auditor TMS |
| DATE: | May 21, 2009 |
| SUBJECT: | Teachers Retirement Obligations and the Proposed Transfer to the Education Fund |

You requested that I provide you with an auditor's perspective regarding a proposal to transfer the teachers' retirement obligation to the Education Fund. My understanding is that the Governor's proposal solely relates to transferring the pension obligation,[1] and not the other post-employment benefits obligation (i.e. retiree healthcare), to the Education Fund.

The issues that arise with this transfer may be categorized into three areas (1) transparency of the cost of education (2) fiscally responsible management of the cost of education and (3) determining the appropriate state revenue source to fund the cost of education.

**Transparency of the cost of education**

Pension and retiree healthcare benefits for teachers (hereafter referred to collectively as teachers' retirement benefits) are inherently a cost of education. The most transparent reporting of the cost of education would include *both of these costs* in a single fund. Currently, the state reports the cost of teachers' retirement benefits in the General Fund and all other education related costs in the Education Fund. Splitting reporting of the costs of education into two funds undermines stakeholders' ability to understand the total cost of education and potentially negatively impacts the ability to make good management decisions about our education system.

**Fiscally responsible management of the cost of education**

In 2005, the Commission on Funding the Vermont State Teachers' Retirement System (the "Commission") found that the State has chronically underfunded the teachers' pension retirement obligation.[2] In addition, the Commission reported "that unless the State changes course soon, Vermont may not be able to catch up with actuarially required contributions without taking draconian measures, and may jeopardize its favorable credit rating." This report also highlighted the need to address the cost of the teachers' retiree healthcare benefit and to provide for a long-term funding mechanism for this obligation as well.

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[1] This is based on a review of the Governor's May 19th Alternative Budget Proposal in which he proposes an appropriation of $40 million to cover the annual contribution. This appears to only address the actuary's recommendation of $41.5 million for the pension contribution and does not address the actuary's estimate of a healthcare contribution of $62.8 million.

[2] The problem of underfunding compounds itself. Underfunding in one year means lost investment returns in future years, resulting in ever larger required contributions.

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Although the Commission produced its report in 2005, the State has continued to underfund the pension obligation and to our knowledge has not established a long-term fiscal plan to fully fund the retiree healthcare benefit. Moreover, the pension retirement obligation remained at 80.9% funded as of June 30, 2008 and the healthcare obligation has not been funded as of June 30, 2008. See the table below for the actuarially recommended contributions to fund the pension and healthcare obligations for FY2009 and the amount appropriated in the FY2009 Big Bill (Act 192):

**FY2009 Contribution**[a]

| Type of Benefit | Recommended | Appropriated |
|---|---|---|
| Pension | $39,612,723 | $37,077,050 |
| Healthcare | $59,124,164 | - $0 - |

[a]These contributions only represent the cost of benefits applied to one year. As of June 30, 2008 the total actuarially estimated cost for pension and retiree healthcare benefits, for current retirees and employees, is $379.5 million and $863.6 million, respectively.

The bottom line is that tough decisions regarding how to fund teachers' pension and healthcare benefits will remain regardless of the fund in which these liabilities are recorded.

**Appropriate state revenue source to fund cost of education**

The State assumed the obligation for funding teachers' retirement benefits prior to the introduction of statewide funding for public education. Currently, there are multiple state funding sources to cover the costs of our statewide education funding system, including property taxes. Transferring the teachers' retirement obligations into the Education Fund does not necessarily mean that property taxes are the default revenue source since the legislature can opt to fund these costs through other means (e.g. a General Fund transfer). This may not be an all or nothing proposition (e.g. property taxes or not property taxes). A possible a viable compromise, which I believe has been discussed in the past, is the following:

(a) Utilize non-property tax sources to catch up on the chronic underfunding of the teachers' retirement obligations, and

(b) Utilize property taxes to fund the cost of teachers' retirement benefits going forward.

The principles of transparency and fiscal responsibility should apply here as well. Whichever course the Legislature and Governor choose, it should be clear to the public how the State plans to fund teachers' retirement benefits now and in the future.